

**Testimony of
Dean Foods Company by Evan Kinser
Milk Marketing Order Hearing
Docket No. AO-14-A76, et al.; DA-07-01
Pittsburgh, PA
December 11, 2006**

Introduction

Hello, my name is Evan Kinser. I am employed by Dean Foods Company as Director of Dairy Policy and Commodities. Dean Foods owns and operates Class I and Class II plants located in and/or regulated, in some form, by all of the 10 Federal Orders impacted by this hearing. I am appearing today to oppose all Proposals being considered at this hearing and to oppose the issuance of an emergency decision. Dean Foods is a member of International Dairy Foods Association (IDFA) and supports its forthcoming testimony.

Undocumented Claim Made by NMPF in Request for Hearing.

I would like to begin my testimony by referring to Exhibit 5, testimony for National Milk Producers Federation (NMPF). This testimony articulates two points justifying the need for the emergency action. Page four contains the second numbered point, which is titled: "The Inadequacy of Current Class I and II Pricing Contributes to Disorderly Marketing in Federal Order Markets." This broad statement by National Milk is a serious concern for the Department in upholding the Act, particularly if the claim made would be true. The good news for the Department is that it is not true when one considers the support NMPF provided and the error is documented by the Secretary's recent decisions.

Exhibit	38
Witness	
Date	Rptr.
Powers Garrison & Hughes	

Proposed Rule published on February 22, 2006

The first evidence cited by NMPF to support this case is a claim about growing difficulty to supply the markets. Interestingly enough in a hearing held in December of 2004 evidence was presented to the Secretary for the purposes of establishing a Transportation Credit in the Central Order to help supply milk to the Class I market in that order. The Secretary concluded the following:

The record does not support concluding that handlers serving major urban areas in other regions of the marketing area (such as, Denver, Oklahoma City, or Tulsa) experience difficulty in attracting milk supplies. This supports concluding that the issues raised by the proponents are at best localized in nature rather than marketwide.

In addition, the record reveals in the testimony of the AMPI, et al., witness that some transportation and assembly costs incurred by handlers for milk delivered to distributing plants are recovered by the marketplace... Record evidence supplied by a Class I handler located in St. Louis indicates that the firm is able to continue receiving, bottling, and selling milk in the St. Louis area. This evidence suggests that milk movements to handlers in the St. Louis area are occurring and meet the order's Class I needs. This evidence provides a basis to conclude that the order provisions attract sufficient milk for fluid use. In this regard, the need for additional government intervention beyond what the order currently provides in meeting the market's fluid demands is not warranted.

...

At best, record evidence demonstrates that if there are difficulties in procuring milk for Class I use, they are isolated to a fraction of the marketing area.
(Central Pooling Proposed Rule 9031 Federal Register / Vol. 71, No. 35 2/22/06)

It is difficult for me to understand how, in a matter of two years, an adequate milk supply has eroded to inadequate and disorderly. It is possible that NMPF found a few select areas (none of which they or any of their supporters testified to), like St. Louis, Mo and tried to extrapolate that local market condition into the broadest of circumstances to encompass every county covered by a Federal Order. The Secretary should not be misled by any localized problem, and should remain consistent in evaluating the entire market (in this case entire system) before concluding a problem exists, particularly a problem requiring emergency action. I would also note that in the

decision referenced the Secretary recognizing that the handlers are able to recover handling and supply costs from the marketplace.

Economic analysis performed by USDA for this hearing

Before leaving this claim of inadequate milk supply, over concern that someone can find an argument that things have so quickly eroded in two years, I would like to point out to the Secretary his own analysis for this hearing. I am referring to Exhibit 1, the hearing notice. Specifically Table 1 found on the third and fourth page titled "Table 1. — Model Results for National Milk Producers Federation Proposed Class I and Class II Changes." My focus is on the line titled "Government Removals of NFDM." This line represents the millions of pounds of nonfat dry milk purchased by the government under the Milk Price Support Program in the years 2007 through 2015. Specifically it details the baseline, the effect of implementation of the proposed Class I price change, the effect of implementation of the proposed Class II Price change and the effect of implementation of the proposed Class I and Class II Price changes. I find it interesting that in the baseline — that is no action to be taken by the Secretary — that there would be sales of NFDM to the government. Yet, to listen to National Milk, it would seem we are in dire straits of not having milk in the US. A more detailed review of the Secretary's own analysis reveals that there is so much milk, that NFDM is going to be purchased by the CCC each year. These proposals would, if adopted by the Secretary, have two negative effects for US taxpayers. First, they would see more of their tax dollars being spent to purchase powder, unless of course the Secretary would only adopt the change in Class II Price. Second, taxpayers would get to pay more for the Class I and Class II dairy products they consume. This is NO deal. Consumers in the United States are far from facing the risk of having no milk to drink. If it is

National Milk's position that the market is failing to move this milk to Class I, that would require another different action; more discussion on this topic later.

The Secretary has already taken action.

NMPF's other points allegedly supporting emergency action are in the third and fourth paragraph of the section. Here the argument is made about rising Class I Over Order Premiums in surplus markets and a great increase in "de-pooling" in recent years. These are correct observations.

What is not noted in the testimony is the connection of these two issues and the fact that higher regulated Class I prices *once pooled* will not solve the problem. It was noted by the Secretary in his Decision on Chicago Regional Order Proposed Rule published in the Federal Register on October 15, 1987 that Class I milk competes with manufacturing milk for a milk supply. In evaluation of the record, the Secretary offered the following conclusion:

"...the very nature of the market tends not to encourage the movement of milk to distributing plants for Class I uses because manufacturing plants are located throughout the marketing area and provide strong competition for producer milk supplies. The result is that distributing plants have difficulty attracting adequate milk supplies at prices that allow them to be competitive with handlers under other nearby orders. (52 Federal Register 38235, 38240 -- October 15, 1987)

If Class I milk is at a regulatory disadvantage (i.e. depooling of Class III milk) handlers would need to pay something beyond the pool price to attract a milk supply (more on this later). To this point, the Secretary has recently recognized the disorderly marketing conditions caused by depooling and promulgated new pooling standards. These changes went into effect at the beginning of this month. This same decision and implementation by the Secretary applies later in the statement when NMPF concluded that today's Proposals are needed to decrease the risk of depooling. In a National hearing regarding all orders, not just the orders where depooling has been an issue, the Secretary should not consider marketing conditions that have already been

addressed in other proceedings, and not been given enough time to be tested before using such conditions as rationales for emergency action or support of an otherwise unjustified price change.

Incorrect Conclusion Drawn by NMPF.

NMPF appears to believe that increases in Class I and Class II milk prices will flow directly to the producers providing that milk. This is a seriously flawed argument. In the discussion of the new Class I and Class II formulas NMPF offers its reasoning behind the Class I and Class II differentials. To quote from the bottom of page 8 of Exhibit 5, Class I and II “differentials are designed to compensate not processors, but rather the suppliers of Class I and II raw milk.”

NMPF’s assumption that Class I and Class II price increases will flow directly back to the raw milk suppliers is something Dean Foods has addressed multiple times – with marketwide pooling, the increases are diluted and will not reach the producers actually providing the service.

Because of marketwide pooling, the prices paid by higher value production, such as Class I & Class II, does not flow to the plant suppliers. Instead, it flows into the pool where it is blended with all the other class values to create a uniform price. The result is that producers and cooperative associations are made indifferent, with the exception of the location differential, between supplying any plant. Thus, a higher Class I Price doesn’t mean something only to the supplier incurring supply costs, it also means something to all producers pooled on the order. So, if the Class I Price increase is going to be sufficient to make the supplier whole, marketwide pooling will allow a non-supplier to reap significant benefit with little or no incurred costs – while we oppose the current proposals – a solution for another day would be to ensure that a

significant portion of any Class I differential revenue flow to the producers supplying Class I market.

Regional inequities.

A major flaw in this Proposal is that it does not have the same impact on all producers. When any class price is increased, because of marketwide pooling, the dairy producer's benefit is limited to the percent of that class in the market's pool. For example suppose there were two Federal Orders, the first was 75% Class I milk, while the second was 30% Class I. Now let's imagine the NMPF proposal is adopted and increases the Class I price by 77 cents a hundredweight. Dairy farmers pooled on the first order would experience a 57.75 cents per hundredweight increase, a result of 75 percent times 77 cents. Now moving to the second order, dairy farmers pooled on the this order would experience a 23.1 cents per hundredweight increase, a result of 30 percent times 77 cents. This is a simplistic representation of the way this proposed change would play out across the 10 orders. In summary, dairy farmers in high Class I utilization markets will get closer to penny for penny increase in their milk check, while dairy producers in lower utilization markets will experience much less of a gain, before recognizing any marketplace dynamics.

This action will create an opportunity for more pool riding. As this disorderly condition develops we will all meet again for another round of Federal Order hearings to discuss the pool provisions.

Potential to Repeat History.

I don't want to bore the Secretary, the Department staff, or the attendees of this hearing, yet I am concerned if we don't learn from history we will be doomed to repeat it. I will attempt to cover a lot of ground in quick order by referring the Department to its own website which contains all the Federal Order hearings since Reform. (<http://www.ams.usda.gov/dairy/hearings.htm>).

I would like to review the rounds of hearings held since 2001 dealing with pooling provisions.

<u>Order Area</u>	<u>Hearing Subject</u>	<u>Start Date</u>
Upper Midwest	Pooling Provisions	June 26, 2001
Mideast	Pooling Provisions	October 23, 2001
Central	Pooling Provisions	November 14, 2001
Northeast	Pooling Provisions	September 10, 2002
Upper Midwest	Pooling Provisions	August 16, 2004
Central	Pooling Provisions	December 6, 2004
Mideast	Pooling Provisions	March 7, 2005

As the Orders took effect from Federal Order Reform handlers began to play by the new rules and the results were different from what was expected. Now, seven hearings later, the Secretary has changed the rules in hopes of restoring orderly marketing conditions. I would add to this list the nearly completed hearing for Transportation Credits in the Southeast and Appalachian Orders. In the decision the Secretary concluded disorderly marketing conditions were present and addressed them as it related to pooling through use of milk receiving Transportation Credits.

Adopting the Proposals being considered today will not lessen disorderly marketing conditions. Instead, it will create new opportunities for pooling games and provide economic incentives for pool diversions. These games will create disorderly marketing conditions, which have been addressed, twice in three different orders in less than seven years, the most recent of which was less than two years ago. There is no reason to believe the circumstances that created those

opportunities have changed so significantly in less than two years to indicate they won't occur again.

Incorrect Assumption made by NMPF.

In reference to lowering the Class I and Class II Prices along with changes to the make allowance for Class III and Class IV, page 21 of NMPF's testimony states the following: "By contrast, the processors of Class I and Class II products are able to pass on increased cost to the market." NMPF implies that Class I and Class II processors operate in a very simplistic cost plus setting. They offer no regard for competitive or demand factors that are a part of the consumer marketplace. I would agree to the point that there are no product price formulas for Class I and II products. However, to extend that statement to mean that price increases are easily provided to customers with no implications is simply not the case.

Consumers respond to price. When we experience a price increase and go to the market in an attempt to pass it along, it is not without an effect to sales. Further, we continue to see new product developments that are formulated in more and more creative ways, some contain dairy products, and some do not, all competing against our products. Increasing Class I and Class II raw milk prices will continue to encourage beverage formulators and consumers to look for something other than milk. While Dean Foods does own Silk and supports the consumption of soymilk, we are at heart a dairy company and do not want to see price changes accelerate the loss of per capita consumption of fluid dairy products.

All Class I and Class II processors operate in a competitive and dynamic environment. One such dynamic is the existence of unregulated Class II processors. With this proposed change to the order system that dynamic could get worse. If these proposals are adopted, a possible occurrence would be increased depooling or more stand alone Class II plants being unregulated. In spite of the fact that the Secretary has taken action to limit the likelihood of depooling, this Proposal will only strengthen the chances that a plant will simply choose to remain outside of the pool. If such happens, as Dean Foods testified to in all the depooling hearings, it will weaken the effectiveness of the order, the very opposite of NMPF's proposed solution (I maintain my stance that NMPF has failed to identify a nationwide problem).

As to California, on page 18 of Exhibit 5, NMPF's testimony, it is reported that the price spread between the California equivalent of FO Class II and Class IV is 3.7 to 3.9 cents. NMPF then claims that this means that raising Class II prices would not cause processors to entertain the use of Class IV products as a substitute for Class II cream.

I won't contest the description of the price spread in California, but disagree as to the claim as to the conclusion that can be drawn. The California pricing system works differently than the Federal Order system, in that their Class II equivalent (Class 2 and 3) is advance priced with only changes six times a year as opposed to the Federal Order lag pricing and monthly changes. The result of this nuance is that over time a reported spread does exist, however it is unknown what the spread will turn out to be until after it has passed. I will refer you to Chart 1 attached to my testimony (Source: http://www.cdfa.ca.gov/dairy/prices_main.html). In looking at this chart it is plain to see that the implied constant advantage suggested by NMPF is not there. In fact,

sometimes the California equivalent of the FO Class II price is higher than the California equivalent of the FO Class IV price and sometimes it is lower. The advantage and disadvantage can be quite large. Thus, if a manufacturer is going to change to alternative ingredients for a price advantage it is going to need to be ready to make that change back and forth continually. This is a serious challenge, to continually alternate ingredients to maintain a consistent product. Thus it seems quite reasonable to me that we don't see a "substantial substitution of butter, butteroil, or anhydrous milk fat for cream" in California. This unpredictably would not exist in the Federal Order where the prices announced would be tied to the same butter market, thereby providing manufacturers of a known and constant margin, to make a one-time permanent change to alternative ingredient(s).

NMPF has offered the wrong solution

Late in the NMPF testimony three points are offered on how its Proposals allegedly better meet the objectives of the Act. The second such point focuses on the cost of suppliers for Class I and Class II milk. This fails meeting the objective of the Act on two fronts. First, the Act is not concerned about an adequate supply of Class II milk. Secondly, the costs borne by suppliers of Class I milk, again the only milk supply of concern of the Act, are not evenly shared by all producers, so to increase the price allows unaffected producers to benefit without incurring the costs. Both concerns are made quite clear in the Secretary's decision relating to the 1987 change to establish Transportation Credits in the Chicago Regional Order. A brief excerpt of that decision follows:

Through the operation of marketwide pooling, that portion of the hauling costs covered by the location adjustments is shared by all producers. However, as noted earlier in this decision, the location adjustment provisions no longer adequately reflect current hauling costs. Thus, handlers who pay for transporting

for milk between plants incur a greater cost than is recognized by the order. Those handlers who incur such additional hauling costs have higher costs than other handlers who do not receive milk from other plants. Moreover, the additional hauling costs, which are not reflected in the order's blend prices, are not shared by all the producers who enjoy the blend prices that results from marketwide pooling. However, as indicated earlier, full recognition of hauling costs in the location adjustment provisions is not a practicable means of dealing with this problem.

The transportation credits provided herein will promote orderly marketing through provisions that are fully consistent with the intent and purposes of the Act. The operation of the credits will improve equity among competing fluid milk handlers by reimbursing a portion of the additional costs incurred when such handlers must reach out to other plants to obtain milk for Class I uses. On the other hand, the costs of such reimbursement will be spread out among all of the market's producers. Thus, all producers who share in the benefits of the higher returns of the fluid market through marketwide pooling will share also the costs of servicing the fluid milk sector of the market on a more equitable basis.
(52 Federal Register 38235, 38242 -- October 15, 1987)

In this same decision the Secretary also considered three ways to address the market problems: increasing the Class I Price, changing the location differential, and implementing Transportation Credits. It was the Secretary's determination then, and we believe should be the Secretary's determination now, that the appropriate solution was neither an increase in the Class I Price nor changing the location differential.

Producer Pay prices

It is interesting to me that some cooperatives are here supporting NMPP's position and agreeing that there are increased costs associated with supplying Class I and Class II and that those prices should be increased for such costs to be captured. Testimony for DFA indicated that it has differing charges through, as I interpreted it, either the agency pricing, contractual arrangements, and/or negotiated adjustments for changes in hauling that capture some costs changes. In direct testimony it was stated that such increases have not been sufficient to cover cost increases. I find

this an interesting contrast to direct testimony in the Southeast and Appalachian transportation Credit hearing. At that hearing DFA testified that in general it was paying over blend in that market as supported by the following quote: "In those areas for the period January through June of 2005, our -- our prices at that comparison would have been ranging from \$.25 below the blend price to \$.30 above the blend price with the majority being at about \$.20 above the blend price."(Mr. Hollon Hearing Transcript FMMO 5&7 hearing January 12 page 264). It seems inconsistent to me that DFA is unable to cover costs with price increases and yet in another hearing report to be paying prices in excess of the Federal Minimum prices. Regardless of the weight the Secretary gave this evidence to support DFA et al's petition, the Secretary did side with them for increasing the transportation rate, and the maximum assessment.

Knowing the Secretary took action to address transportation costs in two orders and listening to the testimony of this hearing it would appear there is a degree of double dipping occurring. The claim was made in the southern orders that transportation costs had increased and compensation was needed. Now we are hearing increases in the same transportation costs and another request for an increase. Just prior to the just referenced hearing the Secretary rejected proposals to promulgate rules for Transportation Credits in both the Central and Mideast order. It seems hard to reconcile recent action taken by the Secretary in Orders to address transportation costs with this hearing's alleged nationwide problem requiring national action related to transportation cost changes. I think that the proponents went looking for evidence of things that provided a response to dairy farmers struggles *without* working for win-win solutions to improve dairy farm prices while improving market performance.

Effectiveness of Over Order Premiums

There has been a lot of discussion thus far about Over Order premiums. It has been stated and/or implied that the cooperatives are unable to pass along costs. I would like to illustrate how in two particular pricing agencies, which were referenced in NMPF's testimony to support the need for action, the Cooperatives have significantly responded to market changes. On page 12 of NMPF's testimony there is a discussion of the changes in Class I prices in Chicago, Milwaukee and Minneapolis. These prices are established by two agencies. Central Milk Producers Cooperative (CMPC) sets the raw milk prices for sales into Chicago and Milwaukee, while Upper Midwest Marketing Agency (UMMA) sets the price for raw milk for sales into Minneapolis. Chart 2, attached at the end of my statement, is a graph of both CMPC and UMMA Target Class I Over Order Premiums from January 2003 to current. Notice the very significant shift in those premiums in May of 2004, which on the surface would look quite peculiar. However, understanding the competitiveness of this milk supply areas and the marketing conditions at the time, it makes sense. In April of 2004 the Producer Price Differential (PPD) for Federal Order 30 was announced at minus \$4.11 in Cook County Illinois. This meant that all the milk that had been pooled was going have a Federal Order minimum price at \$4.11 under the Class III price, while the competitors whom had opted to depool were likely paying near Class III prices to dairy farmers. CMPC and UMMA members realized they had a significant problem, they had to pay more for their milk than they had received or else they would not retain their milk supplies. The following month they increased the premium to recoup their competitive losses. In December of the same year and February of the next negative PPD's occur. This resulted in an increase in the premiums for the months of February and March of 2005.

The point of this illustration is to show how effective Cooperative Over Order Agencies are at recognizing and responding to market conditions that are necessary to remain competitive. To be clear, the Secretary has evaluated the market conditions and determined that depooling is in fact disorderly marketing and offered a rule change to deal with this problem.

NMPF is actually asking for a policy shift disguised as a price increase.

Dean Foods is extremely concerned about the Department recognizing the significant policy shift that is being supported by the proponents in the name of simplification. Said in a very straightforward way the proponents want to disconnect the Class I and Class II prices from the remaining class prices. While, Dean Foods does not agree with National Milk's comments about lack of substitution on Class II butterfat and skim, for argument sake I will stick with the example on Class II skim. If NMPF's proposal is adopted and the manufacturing costs change such that a change is needed to the make allowance, it is highly likely that a situation could develop whereby the Class IV price would be decreased with no impact to Class II prices thus providing dairy processors incentives to utilize NFDM in place of Class II skim – while that would happen in the future, it is the proposal today that would cause that result. This disorderly marketing condition could only be remedied by a hearing to lower Class II skim costs. It seems problematic to me for the Secretary to change policy where it is highly likely that another hearing will be required to address disorderly marketing, when keeping the current policy would prevent such unnecessary work and effort on both the part of the industry and the Department.

Another solution

Dean Foods is disappointed that the Secretary opted to take such quick action on this request by National Milk without considering any alternatives. We appreciate the past practice of the Secretary to request alternative proposals prior to notice of a hearing. Though unable to attend in person, Dean Foods was encouraged and is supportive of the workshop discussion on proposals. However, the handling of this proceeding sends a conflicted signal to the industry. While we continue to have contact from different potential suppliers wishing to supply our plants, there are regulatory options that we feel could improve the pooling provisions. We would suggest the Department consider doing away with or reducing the impact of marketwide pooling. If the Secretary does not want to go that direction, maybe a more specific action would be the tightening of pooling provisions so less milk is associated with/ riding on the Order. We appreciate the actions that the Secretary has taken to improve these provisions, but would suggest that is room for more good to be achieved.

Double payment – don't get penny/penny reduction

To the degree that the Secretary would take a different view from past action and determine that the costs incurred in serving the market should be addressed through higher Class I and II prices, this action does not help us address the problem purported to exist with increasing costs for balancing as reported by National Milk. For example, we have numerous independent producers from whom Dean Foods purchases milk. In these instances, Dean Foods is responsible for milk balancing costs. To the degree these costs have changed, the burden has not been borne by the dairy farmers Dean Foods has paid them. Increasing our Class I Price does nothing to address our balancing costs. Purchasing a balanced milk supply at Class I price for a fully plant is

difficult. It is our belief the Secretary should reject this Proposal since it will not treat all handlers equally. We will experience no change in our balancing costs. Thus we will pay twice for the same service, one in the form of a higher regulated costs, which is supposed to help offset balancing costs, and the other cost will be our realized balancing costs.

It is troubling to us to be here in opposition to higher prices for dairy farmers. We do NOT oppose higher prices to dairy farmers. Yet, we feel that the Class I Price is sufficient such that dairy farmers could receive more money if the pooling was structured in such a way that it provided payment to those who serve the Class I market and a limited reserve supply. Instead it appears to be NMPPF's position that the reserve supply needs to be larger and larger against a flat demand. This proposal to increase the overall price will just make the scramble to be part of the reserve supply in the South more competitive and cause more dilution/pool riding/disorderly marketing and likely result in very little, if any, of these higher Class I and II dollars back into the Southeastern United States dairy producers pockets that supply our plants. We are appreciative of the Secretary's decision to take action to reverse the trend in the Southeast and Appalachian order in his decision from the Transportation Credit hearing and Dean would gladly support actions to increase dairy producer prices when it means positive changes in market structure, something this proposal does not do.

Summary Opposition

Dean Foods believes that National Milk's analysis of the national marketing landscape and resulting conclusions are in error. We would recommend that the Secretary reject all Proposals. The market problems reported to exist don't and action taken by the Secretary is sure to create,

as demonstrated by history, conditions that will be disorderly and lead to more hearings. The significant policy shift proposed should not be taken lightly and in absence of solid evidence of market disruption the Secretary should not use emergency procedures. Dean Foods believes the Secretary has clearly established evaluation criteria for examining the proper relationship between Class I prices and manufacturing prices. Furthermore, we believe that Class I processors and consumers will be adversely impacted if National Milk's proposal to increase Class I and II differential is adopted. Dean Foods believes that if National Milk's Class I and II differential increase proposal would be adopted that there will be far reaching unintended consequences likely creating more disorderly marketing. In full knowledge of this Dean Foods urges the Secretary to reject National Milk's proposal and continue with the existing long-standing policy.